PART IX: INTERNATIONAL TAX

In General

787. What is the difference between a resident alien and a nonresident alien?

A foreign individual who is not a U.S. citizen is labeled as an "alien" for U.S. tax purposes. An alien is either a nonresident alien or a resident alien. A resident alien is a foreign individual who meets either the green card test or the substantial presence test, discussed below, and a nonresident alien is any other foreign individual unless that individual is otherwise eligible to elect to be treated as a resident alien.

A foreign individual meets the "green card test" if he or she has been given permission to reside in the U.S. on a permanent basis by U.S. Citizenship and Immigration Services (or a predecessor) and such permission has not been revoked or judicially determined to have been abandoned by the individual.[1]

For the 2014 tax year, a foreign individual meets the "substantial presence test" if he or she is physically present in the U.S. for at least (1) 31 days in 2014 and (2) 183 days during the three year period that includes 2014, 2013 and 2012, counting only a certain number of days that the individual is present in the U.S. per year, based on the following table:[2]

Year	Days Counted Toward 183 Day Total
2014	All days present in the U.S.
2013	1/3 of days present in the U.S.
2012	1/6 of days present in the U.S.

In general, an individual is treated as being "physically present" in the U.S. for any day in which he or she is actually present in the U.S. at any time of the day. Despite this, an individual does not count the following as days in which he or she is physically present in the U.S.:

(1) Days that the individual commutes into the U.S. for work from a residence in Canada or Mexico if that individual regularly commutes into the U.S. for work (meaning that the individual commutes on more than 75 percent of workdays during his or her working period);

(2) Days that the individual is in the U.S. for less than 24 hours while in transit between two foreign countries;

(3) Days that the individual is in the U.S. as a member of a crew of a foreign vessel;

1. See IRS Publication 519, available at http://www.irs.gov/publications/p519/index.html (last accessed March 11, 2014).
2. IRS Pub. 519, above.

(4) Days that the individual is only in the U.S. because of a medical condition that arose while he or she was in the U.S. and that rendered that individual unable to leave the U.S.; and

(5) Days that the individual was an exempt individual (including individuals temporarily present in the U.S. as foreign-government related individuals, teachers or trainees on a "J" or "Q" visa, individuals present in the U.S. on a student visa, and certain professional athletes in the U.S. for a charitable sports event).[1]

A resident alien will be taxed much in the same way as a U.S. citizen, and thus will be subject to U.S. taxation on all worldwide income. Conversely, a nonresident alien will only become subject to U.S. taxation in the event that he engages in certain activities that create a connection between that individual and the U.S. (see Q 788).

788. When does a foreign individual become a U.S. taxpayer required to file a U.S. tax return?

U.S. citizens and resident aliens (see Q 787) are taxed on worldwide income regardless of where they are located and must generally file a return (though a two-month filing extension will apply for U.S. citizens and residents who are residing overseas).[2]

A foreign individual who is a nonresident alien may be required to file a U.S. tax return if he or she is any of the following:

(1) a nonresident alien engaged in a trade or business in the U.S. during the tax year. If the nonresident alien's only U.S. source income consists of wages that are less than the personal exemption amount ($3,950 in 2014), that alien is not required to file;

(2) a nonresident alien not engaged in a trade or business in the U.S., but who has U.S. income on which the tax liability was not satisfied by withholding at the source;

(3) a representative responsible for filing the return of an individual in (1) or (2);

(4) a fiduciary for the estate or trust if any beneficiary of the estate or trust is a nonresident alien; or

(5) a resident or other fiduciary, or other person charged with the care of the nonresident alien or his or her property, unless the nonresident alien files the return himself or makes other arrangements for a representative to file the return and pay the tax.[3]

1. IRS Pub. 519, above, and IRS Guidance, "Substantial Presence Test," available at http://www.irs.gov/Individuals/International-Taxpayers/Substantial-Presence-Test (last accessed March 11, 2014).
2. See IRS Guidance, "U.S. Citizens and Resident Aliens Abroad," available at http://www.irs.gov/Individuals/International-Taxpayers/U.S.-Citizens-and-Resident-Aliens-Abroad (last accessed March 11, 2014).
3. Treas. Reg. §1.6012-3. See also IRS Guidance, "Taxation of Nonresident Aliens," available at http://www.irs.gov/Individuals/International-Taxpayers/Taxation-of-Nonresident-Aliens (last accessed March 11, 2014).

789. What rules apply when a U.S. citizen or resident alien is married to a nonresident alien and the couple wishes to file a joint U.S. tax return?

If a U.S. citizen or resident alien (see Q 787) is married to a nonresident alien, the couple may elect to treat the nonresident alien as a U.S. resident for tax purposes. The couple may elect this treatment by attaching a statement to this effect to their U.S. tax return for the relevant tax year. The election may be made at the time of filing, or by filing an amended tax return for up to three previous tax years (though in this case, the couple must also elect such treatment for all tax returns that have been filed since the date of the amended return).

The couple must file a joint tax return for the year in which the election is originally made, though separate returns may be filed in later years.

While this election will result in the nonresident alien being treated as a resident alien for income tax purposes, he or she may continue to be treated as a nonresident alien for purposes of Social Security and Medicare taxes.[1]

The election will apply until it is suspended or ended. The election is suspended if, during a later tax year, neither spouse is a U.S. citizen or resident alien. The election is ended if (a) it is revoked by either spouse, (b) one spouse dies, (c) the spouses are legally separated or (d) the spouses have failed to keep adequate records to prove their income tax liability.[2] If the election is "ended," neither spouse may apply to make the election in a subsequent tax year.

790. When a U.S. citizen is a resident of a foreign country and earns income in that foreign country, is that income included in the taxpayer's gross income for U.S. tax purposes?

If a U.S. citizen is employed in a foreign country and files a tax return in that country, that individual will also be required to file a Form 1040 in the United States. A U.S. citizen is taxed on *worldwide* income, regardless of whether that taxpayer lives in the U.S. or in a foreign country.[3]

Despite this, a U.S. citizen with foreign earned income may be eligible to exclude all or a portion of foreign earnings from calculation of his or her income for U.S. tax purposes.[4] "Foreign earned income" includes amounts received by the individual from sources within a foreign country that are attributable to services performed by the individual.[5] Pension and annuity income, amounts paid to the individual by the U.S. as an employee, and amounts paid to the individual under Section 402(b) (taxability of beneficiaries of nonexempt trusts) or

1. IRS Guidance, "U.S. Citizens and Resident Aliens Abroad – Nonresident Alien Spouse," available at http://www.irs.gov/Individuals/International-Taxpayers/U.S.-Citizens-and-Resident-Aliens-Abroad---Nonresident-Alien-Spouse (last accessed March 11, 2014).
2. IRS Pub. 519.
3. See IRS Guidance on the Foreign Earned Income Exclusion, available at http://www.irs.gov/Businesses/Foreign-Earned-Income-Exclusion-1 (last accessed March 11, 2014).
4. IRC Sec. 911(a)(1).
5. IRC Sec. 911(b)(1)(A).

Section 403(b) (taxability of beneficiaries under nonqualified annuities) are excluded from foreign earned income.[1]

791. What is the foreign earned income exclusion?

The foreign earned income exclusion is available if the following requirements are met:

(1) The individual has income received for work performed in a foreign country,

(2) The individual has a tax home in a foreign country, and

(3) The individual meets either (i) the bona fide residence test or (ii) the physical presence test (see Q 792).

According to IRS guidance, an individual's "tax home" is the general area of his or her principal place of business or employment. The individual's principal place of residence is irrelevant for determining the individual's tax home. However, if the individual is not consistently present in one business location, the location of that individual's principal residence may be used as a factor in the tax home determination. If the individual has neither a regular principal place of business or residence, the individual is considered itinerant and his or her tax home is wherever he or she works. The individual's tax home is *not* considered to be in a foreign country if that taxpayer's "abode" is in the U.S.[2]

Example: Joe is a U.S. citizen who is employed on a fishing enterprise in the waters of a foreign country. His schedule provides that he works one month on and one month off. Joe continues to maintain a residence in the U.S., where his family lives and where he returns on his "off" months. Joe is considered to have a "tax home" in the U.S. because his time is split equally between the U.S. and foreign waters. He is not entitled to take advantage of the foreign earned income exclusion, though he may be entitled to deduct his living expenses while living abroad as business travel expenses.[3]

A taxpayer's election to exclude foreign earnings under the foreign earned income exclusion may be revoked by the taxpayer by filing a statement to that effect with the IRS, but if the taxpayer attempts to claim the exclusion within five tax years after the revocation, he or she must apply for IRS approval.[4]

792. What are the bona fide residence and physical presence tests that can allow a U.S. individual to qualify for the foreign earned income exclusion?

A U.S. individual with foreign earned income must satisfy either the bona fide residence test or the physical presence test in order to be eligible to exclude all or a portion of his or her foreign earned income from U.S. income (see Q 790).

1. IRC Sec. 911(b)(1)(B).
2. IRS Pub. 54, available at http://www.irs.gov/publications/p54/ch04.html#en_US_2012_publink100047401 (last accessed March 11, 2014).
3. See IRS Guidance, "Foreign Earned Income Exclusion – Tax Home in Foreign Country," available at http://www.irs.gov/Individuals/International-Taxpayers/Foreign-Earned-Income-Exclusion---Tax-Home-in-Foreign-Country (last accessed March 11, 2014).
4. See IRS Guidance: "Revocation of the Foreign Earned Income Exclusion," available at http://www.irs.gov/Individuals/International-Taxpayers/Revocation-of-the-Foreign-Earned-Income-Exclusion (last accessed March 11, 2014).

An individual may use the "bona fide residence test" to qualify for the exclusion if he or she is either (a) a U.S. citizen or (b) a U.S. resident alien who is a citizen of a country with which the U.S. has an income tax treaty in effect. The bona fide residence test, as the name suggests, is met if the individual has established a residence in a foreign country. The length of the individual's stay and the nature of his or her employment are factors that are considered in determining whether the individual has established a residence in a foreign country, but are not determinative—all of the facts and circumstances of the particular situation must be taken into account.

The IRS has provided bright-line guidance so that the individual must reside in the foreign country for an uninterrupted period that includes an entire tax year, though every individual that resides in a foreign country for at least an entire tax period is *not* automatically considered to have established a residence.[1]

> *Example*: Shannon's domicile (permanent home) is in Brooklyn, New York, but she is assigned to her employer's London office for an indefinite duration. She rents an apartment in London with a one-year lease, though she intends to eventually return to Brooklyn. Assuming all other factors indicate that Shannon has established a residence in London, she will meet the bona fide residence test even though she plans to return to Brooklyn at some point in the future. If Shannon had, for example, been sent to London for a month-long work assignment with a definite return date, she would not be able to satisfy the bona fide residence test. If Shannon had been assigned to her work post in London for 16 months, she may not be able to meet the bona fide residence test because her presence in London is limited in duration.

An individual (whether a U.S. citizen or resident alien) meets the physical presence test if he or she is physically present in a foreign country (or countries) for at least 330 days during a consecutive 12 month period. The individual is not required to establish a residence and there are no requirements as to whether or not the individual intends to return to the U.S. at a specified time under the physical presence test. Unlike the tax home requirement, the individual can be in the foreign country during these days for any reason—there is no requirement that the presence abroad be motivated by business or employment reasons.[2]

793. What is the foreign housing exclusion (or deduction)?

The foreign housing exclusion applies to housing costs paid for with employer-provided funds (including amounts paid by the employer to the employee as taxable foreign earned income), while the foreign housing deduction applies to an individual who pays for foreign housing with his or her self-employment earnings.

The foreign housing exclusion (or deduction) allows an individual to exclude (or deduct) amounts that he or she spends on housing costs while residing abroad, provided that the individual's tax home (see Q 790) is found to be in a foreign country *and* the taxpayer meets either the bona fide residence test or the physical presence test (see Q 792).[3]

1. See IRS Guidance: "Foreign Earned Income Exclusion – Bona Fide Residence Test," available at http://www.irs.gov/Individuals/International-Taxpayers/Foreign-Earned-Income-Exclusion---Bona-Fide-Residence-Test (last accessed March 11, 2014).
2. See IRS Guidance: "Foreign Earned Income Exclusion – Physical Presence Test," available at http://www.irs.gov/Individuals/International-Taxpayers/Foreign-Earned-Income-Exclusion---Physical-Presence-Test (last accessed March 11, 2014).
3. IRC Sec. 911(a)(2).

An individual's "housing amount" is his or her total housing costs for the year *minus* a base amount that is tied to the maximum foreign earned income exclusion (see Q 790) for the year. The amount is 16 percent of the maximum foreign earned income exclusion ($99,200 in 2014, up from $97,600 in 2013, as indexed for inflation)[1], calculated on a daily basis, multiplied by the number of days spent abroad in the tax year.[2]

Housing expenses that qualify for the exclusion or deduction must be reasonable, and can also include housing expenses for the individual's spouse and/or dependents if they live with the individual while he or she is abroad.[3] The cost of purchasing real property, furniture, accessories or other improvements to increase the value of the property are excluded from the definition of housing expenses for purposes of the exclusion (or deduction). Expenses relating to housing, such as the cost of utilities and insurance, are included in the definition of housing expenses for purposes of the exclusion (or deduction).[4]

The amount of a taxpayer's foreign housing exclusion (or deduction) cannot exceed the amount of his or her foreign-earned income for the tax year.

794. Can U.S. individuals employed in a foreign country receive U.S. Social Security credit?

In some cases, a U.S. individual will continue to earn U.S. Social Security credit if he or she continues to be liable for Social Security and Medicare taxes on amounts earned while performing services as an employee in a foreign country. The IRS has issued guidance that provides that Social Security and Medicare taxes continue to apply to wages paid for services performed by a U.S. individual abroad if any of the following are true:

(1) The individual is working for a U.S. employer,

(2) The individual performs services in connection with a U.S. aircraft or vessel and the individual has (a) entered his or her employment contract in the U.S. or (b) the vessel or aircraft touches down at a U.S. port while the individual is employed on it,

(3) The individual is working in a country with which the U.S. has entered a Social Security agreement providing that the foreign earned income is subject to U.S. Social Security and Medicare taxes, or

(4) The individual is working for a foreign affiliate (a foreign entity in which the U.S. employer has at least a 10 percent interest) of a U.S. employer under a voluntary agreement (under IRC Section 3121(l)) entered into by that employer and the U.S. Treasury Department.[5]

1. IR-2012-78 (October 18, 2012), IR-2013-87 (October 31, 2013).
2. IRC Sec. 911(c)(1).
3. IRC Sec. 911(c)(3).
4. IRC Sec. 911(c)(3).
5. See IRS Guidance: "Social Security Tax Consequences of Working Abroad," available at http://www.irs.gov/Individuals/International-Taxpayers/Social-Security-Tax-Consequences-of-Working-Abroad (last accessed March 11, 2014).

The IRS guidance further provides that an individual is "working for a U.S. employer" for purposes of (1), above, if the individual is working for (a) the U.S. government (or instrumentality thereof), (b) another individual who is a U.S. resident, (c) a partnership in which at least two-thirds of the partners are U.S. residents, (d) a trust, in which all of the trustees are U.S. residents or (e) a corporation organized in the U.S., or in any U.S. state (including D.C., the Virgin Islands, Guam, American Samoa and the Northern Mariana Islands).[1]

A U.S. employer who voluntarily enters into an agreement to extend Social Security coverage to its employees working in a foreign country is liable for the entire amount of the covered employees' Social Security taxes that would otherwise apply under Sections 3101 and 3111 if those employees were employed domestically.[2]

The IRS has advised that U.S. individuals who are working in a country with which the U.S. has entered a Social Security agreement providing that the individual's income will *not* be subject to U.S. Social Security obtain a statement from the relevant agency in the foreign country stating that the individual's income is subject to Social Security coverage in that foreign country.

The U.S. Social Security Administration (SSA) will issue determinations that a U.S. individual's income is subject only to U.S. Social Security taxes if the employer contacts the SSA and provides certain basic identifying information about that individual and his or her employment abroad.

795. What are some of the considerations that a U.S. citizen or resident should be aware of when participating in a retirement plan while residing in a foreign country?

While many U.S. citizens and residents who are transferred abroad by multinational employers may continue to be covered by the multinational's U.S. retirement plan, in some cases, a U.S. individual may obtain benefits under a foreign plan. Because U.S. citizens and residents are taxed on their worldwide income, benefits accrued under foreign retirement plans may be subject to U.S. taxation absent a treaty provision that provides otherwise. Most treaties provide that a pension or annuity received from a foreign employer is taxed in the country of residence under its domestic laws.[3]

Treaties with some countries provide for liberalized treatment of retirement accounts—for example, the treaty between the U.S. and the U.K. provides that U.S. citizens residing in the U.K. can deduct, for U.S. tax purposes, amounts contributed to a pension plan established in the U.K.[4]

1. IRC Sec. 3121(h).
2. IRC Sec. 3121(l)(1)(A).
3. See IRS Guidance, "The Taxation of Foreign Pensions and Annuities," available at http://www.irs.gov/Businesses/The-Taxation-of-Foreign-Pension-and-Annuity-Distributions (last accessed March 11, 2014).
4. See the Treasury Department Technical Explanation of the Convention between the U.S. and U.K, Article 17, available at http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/teus-uk.pdf (last accessed March 11, 2014).

Further, while a U.S. individual residing abroad may exclude a portion of his or her foreign earned income from U.S. gross income each year, the foreign earned income exclusion does *not* apply to income received as a pension or annuity while abroad[1] (Q 3549).

Technically, a plan established in a foreign country cannot be "qualified" under IRC Section 401, because of the requirement that a qualified trust be organized under U.S. law.[2] Therefore, a U.S. individual participating in a foreign retirement plan would not be entitled to defer taxation of contributions to the foreign plan in the same manner as would be available in the U.S., absent a treaty provision to the contrary.

However, plans established by certain U.S. multinationals that are established under foreign law may achieve the same tax result if the plan is otherwise qualified.[3] IRC Section 404(a)(4) provides a special rule that allows for the qualification of a trust established outside of the U.S. if the employer contributing to the plan is a U.S. resident, corporation or other entity and the plan is otherwise qualified.

796. Are employer contributions to a foreign retirement account on behalf of a U.S. individual exempt from U.S. reporting requirements?

U.S. individuals residing abroad may become subject to both the FBAR and FACTA reporting rules, and the corresponding penalties for noncompliance, based upon their participation in foreign retirement plans.

Generally, a U.S. individual who has an interest in any "foreign account" is required to file an FBAR (Form TD F90-22.1) if the aggregate value of his or her foreign accounts exceeds $10,000 at any time during the calendar year.[4] The IRS has issued regulations that specifically exempt certain accounts, including plans that qualify under IRC Section 401 and IRA accounts, but these regulations do not provide a similar exemption for *foreign* retirement accounts.[5] Therefore, whether FBAR reporting will be required for a U.S. individual's foreign retirement accounts will likely turn upon whether the individual has a "financial interest" or "signature authority" over the foreign account.

Penalties for failure to file an FBAR can be steep—for willful violations, the civil penalty can equal the greater of $100,000 or 50 percent of the account assets, and the IRS may be entitled to file criminal charges.[6] For non-willful violations, the penalty can still equal up to $10,000 per violation unless the taxpayer can show that there was reasonable cause for failure to file, in which case there is no penalty imposed.[7]

1. IRC Sec. 911(b)(1)(B).
2. IRC Sec. 401(a).
3. IRC Sec. 404(a)(4).
4. See IRS "FAQs Regarding Report of Foreign Bank and Financial Accounts (FBAR) – Financial Accounts," available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/FAQs-Regarding-Report-of-Foreign-Bank-and-Financial-Accounts-%28FBAR%29---Financial-Accounts (last accessed March 11, 2014).
5. See IRS Guidance: "Report of Foreign Bank and Financial Accounts (FBAR)," available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Report-of-Foreign-Bank-and-Financial-Accounts-%28FBAR%29 (last accessed March 11, 2014).
6. 31 USC 5321(a)(5).
7. See IRS FS-2011-13 (December 2011).

Because of the steep penalties imposed upon taxpayers who do not comply with FBAR reporting obligations, the IRS has recently issued guidance to allow certain "low risk" nonresident U.S. taxpayers who have resided outside of the U.S. since January 1, 2009 to catch up on filing delinquent U.S. income tax returns and FBARs with respect to their foreign accounts. Whether an individual is "low risk" or not will be determined based on the amount of U.S. income tax owed (less than $1,500 per tax year is low risk), and these delinquent returns will be processed in a streamlined manner absent any other high risk factors.[1] The plan is described by the IRS as a method to provide assistance to U.S. citizens residing abroad, including dual citizens, with foreign retirement plan issues.[2]

In addition to FBAR filing requirements, a U.S. individual may be required to comply with FATCA and report any foreign financial assets with an aggregate value of over $50,000 (or higher amount, if the Secretary otherwise provides) on Form 8938, Statement of Specified Foreign Financial Assets, attached to his or her U.S. tax return.[3]

797. What assets of a foreign individual (nonresident alien) are subject to U.S. estate tax?

Unlike a U.S. citizen, who is subject to estate taxation on worldwide assets, the gross estate of a nonresident alien (meaning, a foreign individual who is not a U.S. citizen or resident alien) only includes property that is situated in the U.S. at the time of the nonresident alien's death.[4]

For purposes of determining what property is situated in the U.S., any property which the decedent has transferred, by trust or otherwise, which would be taxable within the provisions of IRC Sections 2035 through 2038 (relating to termination of certain property interests within three years of death, transfers with a retained life estate or to take effect at death, and revocable transfers), is deemed situated in the United States if it was so situated either at the time of the transfer or at the time of death.[5]

For a decedent who was a nonresident alien at the time of death, property is considered located in the U.S. if it falls into any of the following categories:

(1) Real property located in the U.S.;

(2) Tangible personal property located in the U.S., including clothing, jewelry, automobiles, furniture or currency. Works of art imported into the U.S. solely for public exhibition purposes are not included;

1. See IRS Instructions for New Streamlined Filing Compliance Procedures for Nonresident, Non-Filer U.S. Taxpayers, available at http://www.irs.gov/uac/Instructions-for-New-Streamlined-Filing-Compliance-Procedures-for-Non-Resident-Non-Filer-US-Taxpayers (last accessed March 11, 2014).
2. IR-2012-65 (June 26, 2012).
3. IRC Sec. 6038D(a).
4. IRC Sec. 2103.
5. IRC Sec. 2104(b).

(3) A debt obligation of a citizen or resident of the U.S., a domestic partnership or corporation or other entity, any domestic estate or trust, the U.S., a state or a political subdivision of a state or the District of Columbia; or

(4) Shares of stock issued by domestic corporations, regardless of the physical location of stock certificates.[1]

However, in the case of a nonresident alien who dies while in transit through the U.S., personal effects are not considered located in the U.S. Neither is merchandise that happens to be in transit through the U.S. when a nonresident alien owner dies.

The IRS has also addressed certain assets and found that they are specifically excludible from a nonresident alien's gross estate as being "without the U.S." The following nonexhaustive list of the property owned by a nonresident alien is *not* considered to be situated within the U.S. for calculating the gross estate:

(1) A bank account that is not used in connection with a U.S. trade or business;[2]

(2) A deposit or withdrawable account with a savings and loan association chartered and supervised under federal or state law or an amount held by an insurance company under an agreement to pay interest on it. But the deposit or amount must not be connected with a U.S. trade or business and must be paid or credited to the decedent's account;[3]

(3) A deposit with a foreign branch of a U.S. bank if the branch is engaged in the commercial banking business;[4]

(4) A debt obligation the interest on which would be exempt from income tax under IRC Section 871(h)(1), relating to tax-exemption for interest earned by nonresident aliens with respect to portfolio debt investments;[5]

(5) Stock issued by a corporation that is not a domestic corporation, even if the certificate is physically located in the United States;[6]

(6) An amount receivable as insurance on the decedent's life;[7]

(7) Certain original issue discount obligations;[8] and

(8) Certain stock that a nonresident alien owns in a regulated investment company (RIC) at the time of his or her death.[9]

1. Treas. Reg. 20.2104-1(a).
2. See IRS Guidance: "Some Nonresidents with U.S. Assets Must File Estate Tax Returns," available at http://www.irs.gov/Individuals/International-Taxpayers/Some-Nonresidents-with-U.S.-Assets-Must-File-Estate-Tax-Returns (last accessed March 12, 2014).
3. IRC Secs. 2105(b)(1), 871(i)(3).
4. IRC Sec. 2105(b)(2).
5. IRC Sec. 2105(b)(3).
6. IRC Sec. 2104(a).
7. IRC Sec. 2105(a).
8. IRC Secs. 2105(b)(5), 871(g)(1).
9. IRC Sec. 2105(d).

If the decedent was a citizen or resident of one of the countries with which the U.S. had an estate tax treaty in place, the provisions of the treaty may override the normally applicable provisions of the Internal Revenue Code that are outlined above.

798. How does the estate of a foreign individual (nonresident alien) calculate the amount of U.S. estate tax owed?

The estate tax computation base of a nonresident alien's estate consists of his or her taxable estate plus any taxable gifts made during his or her lifetime.[1] The taxable gifts of a nonresident alien made after 1976 (other than gifts included in the gross estate) also form part of the tax base upon which the estate tax is computed. The adjusted taxable gifts of a nonresident alien are computed in the same manner as for a resident citizen.[2]

Once the taxable estate of the nonresident alien decedent is determined, the mechanics of the actual tax calculation and the applicable rate schedule (before the unified credit) are the same for nonresident alien decedents as for citizen-residents. However, a very important difference comes into play in the use of the unified credit, which is greatly reduced for nonresident alien decedents. This, of course, indirectly results in a higher effective tax rate. See Q 800 for a discussion of the unified credit as applied to nonresident aliens

799. Is the estate of a foreign individual entitled to the same deductions as a U.S. individual?

A nonresident alien's taxable estate is determined by deducting the following items from the alien's gross estate:

(1) Expenses, indebtedness, taxes and losses. These items may be deducted only in the proportion that the value of the decedent's gross estate in the U.S. bears to the value of the entire estate, wherever situated.[3] Thus, the deductible portion of each item is limited to the amount of each item multiplied by a fraction, the numerator of which is the value of the property located in the U.S., and the denominator of which is the value of the entire gross estate, wherever located.

(2) Charitable bequests. Charitable bequests are fully deductible if made to organizations meeting the requirements for an estate tax charitable deduction under IRC Section 2055 and are computed in the same manner as similar deductions allowed the estates of U.S. citizens and residents.[4]

(3) Marital Deduction. The marital deduction is not available for property passing to a surviving spouse who is an alien (either a resident alien or a nonresident alien) unless the property passes to the spouse in a qualified domestic trust (QDOT) or is placed in a QDOT before the date on which the decedent's estate tax return is

1. IRC Sec. 2101(c).
2. IRC Sec. 2101(b), (c).
3. IRC Sec. 2106(a)(1).
4. IRC Sec. 2106(a)(2).

> filed.[1] The policy behind this limitation is that if the surviving spouse is an alien, there is a considerable likelihood that the marital deduction property will eventually be moved abroad, and not be taxable upon the death of the surviving spouse. This possibility can be eliminated, however, through the QDOT mechanism, which assures that the property in question will remain subject to U.S. estate tax upon the death of the surviving spouse.

Allowance of Deductions. A deduction is allowed only if the executor discloses in the estate tax return the value of that part of the gross estate not situated in the U.S.[2]

800. May a nonresident alien's estate claim an estate tax exemption upon the death of the nonresident alien?

The unified transfer tax credit in the case of a nonresident alien decedent is only $13,000.[3] This effectively exempts only the first $60,000 of taxable estate from tax, a considerably lower threshold than applies to a domestic decedent (see Q 711).

A special rule applies if the decedent was a nonresident of the United States, but resided in a U.S. possession (e.g., Puerto Rico, Guam) and was a U.S. citizen only because of birth or residence in, or citizenship of, the possession. Under these circumstances, the decedent is considered to be a "nonresident noncitizen,"[4] and the estate of a decedent in this category qualifies for a credit that is the greater of:

(1) $13,000, or

(2) $46,800 multiplied by the ratio that the value (at death) of that part of the decedent's gross estate that is located in the U.S. bears to the entire value of the decedent's gross estate.[5]

In either case, the credit may not be more than the amount of the estate tax.[6] Further, the amount of the available credit is reduced by the value of any lifetime gifts made by the nonresident alien-decedent.[7]

801. Can a life insurance policy or annuity contract issued to a U.S. person by a foreign life insurance company qualify for the tax benefits traditionally afforded to U.S. life insurance policies?

Generally, foreign insurance companies cannot sell insurance products to U.S. persons without becoming subject to U.S. regulation. Despite this, if a U.S. person resides in a foreign country for an extended period of time, it is possible that he or she may choose

1. IRC Sec. 2056(d).
2. IRC Sec. 2106(b).
3. IRC Sec. 2102(b)(1).
4. IRC Sec. 2209.
5. IRC Sec. 2102(b)(2).
6. IRC Sec. 2102(b)(4).
7. IRC Sec. 2102(b)(3)(B).

to purchase a life insurance or annuity product from a foreign insurance company in that country. In order for a foreign-issued life insurance or annuity product to qualify for the same tax preferences given to domestic products, it will be required to comply with the U.S. requirements for these products (including, for example, the definition of "life insurance contract" under Section 7702 or the annuity provisions of Section 72).

Further, under the IRC, most annuity contracts issued by domestic insurance companies are exempt from the original issue discount (OID) rules (discussed in Q 437 to Q 474).[1] An annuity contract issued by a foreign insurance company will be subject to the OID rules, however, unless that insurance company is subject to tax under subchapter L with respect to income earned on the annuity contract. If the insurance company is not subject to tax under subchapter L, the annuity contract will be included in the definition of a debt instrument and the growth on the annuity cash value can be subject to tax as interest income even if payouts under the annuity contract have not yet begun.[2]

In the context of variable life insurance contracts, a contract will not qualify as a variable life insurance contract unless it is a "variable contract" for purposes of IRC Section 817(d). Under this provision, the amounts received under the variable contract must be segregated into an account that is separate from the company's general asset accounts *under state law or regulation*.[3] The question that arises in this context is whether an insurance company that segregates its assets pursuant to *foreign law* will qualify. The IRS has found that a foreign insurance company who elects to be taxed as a domestic company under IRC Section 953(d) (meaning it will be subject to subchapter L taxation), and who segregates amounts received under life insurance contracts from general company assets under foreign law, can meet the requirements of Section 817(d).[4]

This, however, leaves open the possibility that variable contracts issued by a foreign insurance company that has *not* elected to be taxed as a domestic company will not qualify for treatment as such under the IRC.

802. What considerations should a U.S. citizen or resident alien be aware of when he or she owns or disposes of real property that is located in a foreign country?

The general rule that a U.S. citizen or resident alien is taxed on all worldwide income applies in the case of a sale of real property in the same manner as income from any other source.[5] Therefore, a U.S. citizen or resident alien who sells real property that is located in a foreign country must report and abide by U.S. tax rules relating to the sale of real property (see Q 7781).

Thus, for example, a U.S. citizen who sells a principal residence that he or she has used as a principal residence for two of the five preceding tax years is entitled to exclude a portion

1. IRC Sec. 1275(a)(1)(B).
2. Treas. Reg. §1.1275-1(k).
3. IRC Sec. 817(d)(1).
4. Let. Rul. 200919025.
5. See IRS Publication 544, available at http://www.irs.gov/pub/irs-pdf/p544.pdf (last accessed March 12, 2014).

of the gain from taxation in the U.S. in the same manner as though the property was located within the U.S. (see Q 7781).

Though the U.S. citizen or resident alien may also be required to pay taxes upon disposition of foreign-located real property both in the U.S. and in the country in which the property is situated, he or she will be entitled to claim a credit for certain foreign taxes paid on his or her U.S. tax return.[1]

Further, a U.S. citizen or resident alien may be entitled to deduct any real property taxes that are imposed by a foreign country on his or her U.S. tax return.[2]

U.S. Individuals and Taxation in Mexico

803. Can U.S. individuals purchase land in Mexico for investment purposes?

Generally, yes, though there are certain conditions and restrictions that must be understood first. U.S. individuals and other non-Mexican individuals may directly own real estate in Mexico. However, U.S. individuals may *not* directly own any real estate parcels within an area designated as the "restricted zone" (see Q703).

From a very practical position, any U.S. individual seeking to purchase real property in Mexico should understand the following basic premises:

(1) The real estate industry in Mexico is generally unregulated. Real estate agents and brokers are neither licensed nor regulated as they are in the U.S. In addition, there is no "Office of the Real Estate Commissioner" or equivalent in Mexico to provide any type of consumer protection or advocacy. In any Mexican real property transaction, extreme caution must be exercised before executing any contract.

(2) Any acquisitions in the "restricted zone" by a U.S. individual must be undertaken with the following entities:

- Bank;
- Public Notary; or
- The buyer's attorney (preferably a licensed Mexican attorney).

804. What is a restricted zone purchase for purposes of real property transactions taking place in Mexico?

Mexican law prohibits the direct ownership of real estate within what is designated as the "restricted zone," which is defined to include "all land located within 100 kilometers (about 62 miles) of any Mexican border, and within 50 kilometers (about 31 miles) of any Mexican coastline."

1. See IRS Publication 54, available at http://www.irs.gov/publications/p54/ch05.html#en_US_2012_publink100047596 (last accessed March 12, 2014).
2. IRS Pub. 54.

In order for a U.S. individual to acquire property within the restricted zone, the buyer must first form a "fideicomiso"[1] with the buyer's bank serving as the title owner of the real estate, and as the trustee to the trust, with the U.S. buyer being the trust beneficiary.[2] This structure allows the U.S. buyer to enjoy complete and unrestricted use of the real estate.

Essentially, the seller of the property sells the parcel to the bank as the trustee of the fideicomiso. The bank has a fiduciary obligation to follow instructions provided by the U.S. trust beneficiary, who will retain all ownership rights, while the bank retains title. Under this arrangement, the U.S. person can sell the property that is held in trust at its market value to any ready, willing and able buyer. In addition, the buyer can instruct the bank to lease the property to any person at terms favorable to the beneficiary.

805. What are the tax and reporting obligations of U.S. purchasers of real property in Mexico?

Based on the scenario described in Q703, the primary issue becomes whether or not the U.S. individual is required to report his interest in the fideicomiso to the IRS as required pursuant to current Code provisions.[3]

Recent guidance issued by the IRS has indicated that the fideicomiso is not deemed a trust for U.S. tax purposes, thus it is treated as a disregarded entity.[4] This means that the trust is not subject to otherwise applicable reporting requirements.[5]

Accordingly, any gains resulting from the sale of the Mexican property by the trust will be recognized by the U.S. beneficiary and subject to the favorable maximum current capital gains rate of 20 percent, as opposed to the maximum rate of 39.5 percent applicable to ordinary income. However, the receipt of any rental income must be reported as income on the U.S. individual's return.

806. I have Mexican clients seeking to open investment accounts in the US. How should they structure their investment holdings in a tax efficient manner?

First of all, citizens and residents of Mexico are taxed on income sourced on a worldwide basis at a rate of 30 percent. Taxable income includes all types of income, whether received in cash, in services or in credit, regardless of the source. This necessarily includes income derived from passive investment activities including dividends, interest and capital gain income.

Because of the above, the concept of "tax efficiency" in establishing investment accounts may be problematic for Mexican investors based on their enacted tax statutes and interpretations. As such, the conventional posture of a Mexican investor establishing investment accounts

1. In essence, a Mexican trust that will hold real estate.
2. In addition, the bank as trustee is also required to apply to the Ministerio Público (Minister of Public Affairs) for permit to acquire real estate and to establish the trust.
3. Forms 3520 and 3520-A, pursuant to Notice 97-34, Sec. IV, 1997-1 CB 422
4. Rev. Rul. 2013-14
5. Similar decision reached in Let. Rul. 201245003.

in his/her name becomes a simple proposition to the extent that he/she would be taxed on any earnings generated from investment activities. But, to the extent that the investment activities emanating from a U.S. broker/dealer will result in U.S. source income earned by a nonresident investor [1], taxes will be due to the U.S. on the same income.[2] As such, the Mexican investor would be taxed twice on the same investment income.

To avoid such calamity, some advisors suggest that the Mexican investor consider utilizing a corporate structure in opening the account in place. However, that may be problematic under the Controlled Foreign Corporation (CFC) scheme under Mexican tax law where CFC's are defined as non-Mexican companies whose tax rate in its respective jurisdiction is less than 75 percent of the income tax that would have been paid in Mexico in accordance with their tax laws.[3] Thus, the desire to utilize a corporation domiciled in a low tax jurisdiction or tax haven will create unwanted and unnecessary scrutiny by Mexican tax authorities.[4] Thus, such advice tends to be harmful to the investor.

Other advisors recommend the use of passthrough entities[5] wherein one of the partners (or in the case of the LLC, a member) is an irrevocable non-Mexican trust wherein the Mexican investor is a beneficiary of the trust and could enjoy the beneficial interests of asset accumulation under a foreign trust as to Mexico. The trustee of such trust should be a non-Mexican entity or person located in a jurisdiction with a lower tax rate, as his or its ownership may be taxed as income. However, the net result of such arrangement would be the non-taxation of the investment income in Mexico as the Mexican client would no longer maintain control over the investment – a critical issue from a Mexican tax standpoint.

U.S. Individuals and Taxation in Canada

807. Why is residency significant in Canadian taxation, and how is Canadian residency determined for tax purposes?

Canada's jurisdiction to tax an individual is generally established based on one of two ways: one way is applicable to residents of Canada, and the other is applicable to non-residents.[6] Unlike the U.S., residency is the basis for taxation in Canada. The rationale for the distinction in taxation treatment between resident and non-resident individuals is based on the significance of the individual's connection to Canada. A resident of Canada is considered to have significantly stronger ties to Canada than that of a non-resident, and thus is more likely to avail himself of the benefits of Canadian resources. Accordingly, a resident of Canada is taxed on worldwide income, as distinct from a non-resident of Canada who is taxed only on Canadian sourced income.

Given the significance of residency, it is surprising that the term "resident" is not defined in the Income Tax Act ("ITA"), nor is there a "bright line test" that can be used as a guide to

1. This assumes that the investment portfolio includes US registered securities.
2. IRC Sec. 881(a)(1)
3. Article 86 of the ITL (domestic tax law)
4. Servicio de Administracion Tributaria (better known as "Hacienda")
5. Partnerships, Limited Liability Companies, etc.
6. *Income Tax Act*, R.S.C. 1985, c. 1 (the "ITA"), s. 2.

determine if one is a resident of Canada or not. Other than the "deeming" provisions in the ITA, an individual is required to evaluate a number of factual considerations, in their totality, to determine whether the individual is a resident or non-resident of Canada.

In most situations the determination of residency is relatively clear. However, in situations where a U.S. resident spends significant amounts of time in, or has significant ties to Canada, the determination is much more difficult to make. In addition, the fact that an individual is a U.S. resident does not preclude a finding that the same individual can also be considered a Canadian resident. An individual can be resident of more than one country in any given taxation year.

See Q 808 for a discussion of when an individual is considered a resident of Canada for tax purposes. See Q 809 for a discussion of part-time residents of Canada and Q 810 for the treatment of non-residents.

808. When is an individual considered a "resident" of Canada for tax purposes?

The Canada Revenue Agency ("CRA") provides guidance on residency and taxation in *Folio S5-F1-C1: Determining an Individual's Residence Status*. The concept of residence, and whether one is considered to be a Canadian resident, involves an assessment of a combination of factual indicators, some factors of which are considered as being more significant (the primary factors) compared to others (the secondary factors). That said, no one factor is determinative. An assessment of all the factors guides the eventual determination of residency.

Primary factors include:

- Having a Canadian residence that is ordinarily inhabited; that is to say having a residence in the normal course as compared to special, occasional or casual use (house, cottage, condo, etc.);
- Having a spouse or partner who is resident in Canada; and
- Having dependents, such as minor children, who are resident in Canada.

Secondary factors include, but are not limited to:

- Health coverage in a province;
- Personal property in Canada such as cars, recreational vehicles, or personal effects;
- Possessing a driver's license in one of the provinces, or holding a Canadian passport, or work/immigration status in Canada;
- Economic ties, such as employment or business in Canada;
- Having active bank accounts, investments, or Canadian based credit cards;
- Having a seasonal dwelling place in Canada; and

- Affiliations with religious, social or business related organizations or entities, such as a church, social or golf club, or membership in a Canadian business or professional organization.

A U.S. individual can also be deemed to be a Canadian resident by operation of statute (the deeming provisions of the ITA),[1] even if an assessment of the factors would result in a different determination. In most instances, however, the deeming provisions of the ITA are typically engaged if the individual is not resident in Canada throughout the year, and thus fails to meet the factual threshold.

The most common of the statutory deeming provisions applies to a sojourner.[2] Where a US resident sojourns in Canada for a ~~collective~~ of 183 or more days in any given calendar year, that individual will be deemed by operation of subsection 250(1)(a) of the ITA to be a resident of Canada, whether or not the individual has a permanent residence in Canada, and whether or not the individual has any other significant ties to Canada. The deeming provision deems an individual who is present in Canada for more than 183 days to be a resident of Canada for that year, for taxation purposes, regardless of the reason for the stay in Canada. Examples of situations where this may affect an unsuspecting U.S. resident include U.S. individuals who vacation in vacation homes in Canada, or individuals that work in Canada (depending on the hours of work).

There is some discrepancy as to how part of a day is treated for the purposes of the sojourning rule. The general approach to a part day is that any stay in Canada that exceeds a half-day in length is considered to be a full day for the purposes of the sojourning rule. The CRA, however, can take a different approach in different contexts.

There are other situations in which an individual is deemed to be a Canadian resident by operation of statute for tax purposes even though the individual does not reside in Canada, although most of these situations do not affect U.S. residents. For example, individuals that are members of the Canadian armed forces, and federal or provincial civil servants stationed outside of Canada in a given taxation year, are deemed to be Canadian residents for tax purposes.

Since it is possible to be resident of both Canada and the U.S. simultaneously, a U.S. citizen who is resident of Canada will still have U.S. tax filing obligations and potential U.S. tax liabilities that are not mitigated by Canadian federal tax credits (FTCs) or the Canada-U.S. tax treaty. However, it is possible with proper tax planning to minimize double taxation.

The primary consequence of being a Canadian resident for tax purposes to U.S. individuals is that they become responsible for filing a return on their worldwide income in both countries. Non-residents of Canada are only liable for tax on Canadian source income. Section 115(1) of the ITA determines taxable income in Canada for non-residents. "Passive income" from Canadian sources will generally be subject to Part XIII withholding tax, although the rate of withholding tax may be reduced or eliminated by virtue of the Canada-U.S. Tax Treaty.

1. See subsection 250(1) of the ITA.
2. Subsection 250(1)(a) of the ITA.

809. What is a part-year resident of Canada for tax purposes?

A part-year resident typically applies to an individual who enters Canada for the first time as a resident, or who leaves Canada permanently. A U.S. resident who becomes a Canadian resident for tax purposes in any given year (because of factual considerations such as moving to a permanent residence in Canada), or a U.S. resident who is also a Canadian resident but decides to permanently leave Canada will likely be considered a part-time resident of Canada in both the year of entry and in the year of departure. Part-time residency status applies to individuals who have ties in Canada that have been severed mid-year.

In these situations, the ITA alters the "taxation year" of the individual to be the part of the year that the individual was in Canada prior to departure, or the part of the year that starts when the individual entered Canada and ends at the end of that calendar year. For the part-year that the individual is a resident of Canada, he or she is subject to taxation on worldwide income. For the part-year that the individual is a non-resident of Canada, he or she is only subject to taxation on Canadian sourced income.

Planning Point: For example, consider a U.S. resident entering into Canada for the first time on a "permanent" basis. From January 1 to the date of entry into Canada, the US resident is considered to be a non-resident for tax purposes and thus would only be subject to taxation on Canadian sourced income, if any, for the first part of the year. From the date of entry into Canada to December 31, the U.S. resident is also considered a Canadian resident for tax purposes and is subject to taxation on their worldwide income. *Marcela Aroca, B.Sc., J.D., Principal: Aroca Litigation, Windsor, Ontario.*

810. When is an individual considered to be a non-resident of Canada for tax purposes?

If an individual is not considered a resident of Canada by fact, or is not deemed to be a resident of Canada by statute, then the individual will be considered a non-resident. Non-residents are not taxed on their worldwide income, but rather only on income that is derived from a source in Canada. This would include, for example, business or employment income in Canada or monies generated from a disposition of taxable Canadian property. A non-resident is also subject to Part XIII withholding tax on income earned from property held in Canada, otherwise known as "passive" income. Examples of passive income include the payment of dividends, royalties or interest.

U.S. citizens who are non-residents of Canada but have Canadian source income must file a T1-NR Individual Tax Return with the CRA.[1] U.S. residents who are non-residents of Canada and earn only passive income need not file a Canadian tax return. Instead, a withholding tax is withheld by the payor and remitted directly to the CRA on behalf of the non-resident. This requirement imposed on payers of monies going to non-residents simplifies the CRA tax collection efforts as against non-residents.

1. http://www.cra-arc.gc.ca/formspubs/t1gnrl/nnrsdnts-eng.html 2013 Income Tax and Benefit Package (for non-residents and deemed residents of Canada)

811. When does a U.S. individual establish permanent residency in Canada?

The term "permanent resident" has a specific meaning in the immigration context that is beyond the scope of this article. For this discussion, a "permanent" resident of Canada is treated as a resident of Canada for tax purposes, as detailed in Q 807 to Q 810.

U.S. individuals are most likely to acquire Canadian residency for tax purposes by fact; that is, they will be determined to be a Canadian resident based on their ties to Canada, or, more simply, because he or she ordinarily resides in Canada. The length of time the individual spends in Canada is not a factor; rather, it is the ties to Canada that are determinative.

U.S. individuals can also sojourn in Canada for more than 183 days in a calendar year, in which case the individual is treated as a Canadian resident for tax purposes, whether or not their primary "living" connection is with Canada. In this case, the length of time in Canada is the only factor, and the reason for the individual's stay in Canada is irrelevant.

Interestingly, it is possible to be a resident of Canada as determined by fact, and yet spend less than 183 days in Canada per year.

812. What are the general filing requirements for U.S. citizens living in Canada on a full-time basis?

The U.S. bases taxation on both residency and citizenship. U.S. citizens are taxed on their worldwide income (income from all sources derived from inside and outside of the U.S.), whether they are resident in the U.S. or not; that is, they do not need to be physically in the U.S. for this liability to arise. U.S. citizens must file Form 1040, U.S. Individual Tax Return with the IRS annually.[1]

U.S. citizens that reside in Canada are also taxed in Canada on their worldwide income. Canadian resident taxpayers – including any U.S. citizens resident in Canada – must file a T1 Individual return with the CRA annually.[2] The deadline for filing a T1 income tax return is April 30th of the following year, unless the individual earns business, professional or self-employment income, in which case the individual has until June 15th to file his or her T1 tax return. It is important to note that payment of any tax owing to the Canadian government is due on or before April 30th of the year following the tax year, regardless of when the individual's tax return is due.

Part-year residents, which include U.S. citizens who become Canadian residents for tax purposes during the year, will have part-year tax returns to file in both Canada and the U.S. In Canada, the part-year tax return has the same filing deadlines as the general T1 income tax return applicable to Canadian residents.

813. Can U.S. citizens living in Canada be subject to double taxation?

Yes, it can happen, but the double taxation effects can be diminished or eliminated in most circumstances.

1. http://www.irs.gov/uac/Form-1040,-U.S.-Individual-Income-Tax-Return
2. http://www.cra-arc.gc.ca/formspubs/t1gnrl/menu-eng.html General income tax and benefit package for 2013

Although U.S. citizens have U.S. tax-filing requirements by virtue of their citizenship rather than only residency,[1] the residence status of a U.S. citizen in Canada may affect their ultimate U.S. tax liability in dollar terms. Ultimately, U.S. citizens residing in Canada on a full-time basis will likely be responsible for filing tax returns in both jurisdictions and must declare their worldwide income, all of which is subject to taxation. This, of course, can create a situation where the individual is subject to double taxation - tax owed in Canada and tax owed in the U.S. for the same monies earned. Fortunately, the operation of the Canada-U.S. Tax Treaty,[2] and the Foreign Tax Credit system in Canada and in the United States should mitigate if not avoid double taxation.

The Canada-U.S. Tax Treaty operates to alleviate double taxation based on a system of rules that determines which jurisdiction should be the "primary taxing jurisdiction," even when both jurisdictions may claim the right to tax the same income. These rules are found in Article XXIV of the Canada-U.S. Tax Treaty.

Article XXIV of the Canada-U.S. Tax Treaty provides that an individual should pay tax to the jurisdiction where he or she resides, unless there is a "fixed base" in the other country. A fixed base is usually a permanent home (it can also be an office). The effect of this would have a U.S. citizen that lives in Canada (and having his or her permanent home there) report his or her worldwide income on his or her Canadian tax return and pay tax in Canada accordingly. Of course, the fact that Canada is the primary taxing jurisdiction does not alleviate the burden that lies on the U.S. citizen to also have to report that same income in the U.S. What alleviates the double taxation that would result is the Foreign Tax Credit[3] regime that allows the individual, who, for example, has paid Canadian income tax on Canadian-source income (which is subject to U.S. reporting and potentially tax obligations) to reduce the amount of U.S. income tax on the income that has already been taxed in Canada. See Q 791 for a discussion of the foreign earned income exclusion.

Take, for example, Taxpayer A, who is a U.S. citizen and lives in Canada, and is therefore considered a resident of Canada for tax purposes. Taxpayer A must declare worldwide income and pay tax in Canada, and must also declare all worldwide income in his or her U.S. income tax return. However, as Canada is the primary taxing jurisdiction, Taxpayer A will likely receive foreign tax credits on certain income in the U.S. to the extent that taxes are paid in Canada. In this manner, most, if not all, income is only taxed once, and Canada has the primary claim to the tax. However, where there is more tax owed in the U.S. than in Canada, then Taxpayer A may owe an additional tax liability in the U.S.

Although Article XXIV gives basic treaty protection from double taxation to a U.S. citizen working in Canada, an individual can elect out of treaty protection. Such an election is made

1. Since the 16th Amendment to the US Constitution the US has taxed worldwide income of its citizens. This is in contrast to Canada that only taxes the worldwide income of Canadian *residents* as defined by the Income Tax Act. Generally, Canadian citizens who are not deemed to be *residents* for tax purposes are not subject to Canadian taxation on their worldwide income, only any Canadian source income.
2. http://www.fin.gc.ca/treaties-conventions/usa_-eng.asp "Convention Between Canada and the United States With Respect to Income and on Capital" Fifth Protocol
3. http://www.irs.gov/taxtopics/tc856.html IRS: Topic 856 - Foreign Tax Credit http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s5/f2/s5-f2-c1-eng.html CRA Income Tax Folio: S5-F2-C1 Foreign Tax Credit

commonly in the case of a U.S. citizen living in Canada but wants to be taxed exclusively as a U.S. citizen for either tax or non-tax reasons. In this case, the U.S. is the primary taxing jurisdiction, but double taxation may be eliminated as the individual could claim a foreign tax credit for taxes paid in the U.S. on income reported in Canada. However, a tax liability may arise in the circumstance where the total of Canadian tax exceeds the amount of tax paid in the U.S. The difference between the amount of tax paid in the U.S. and the amount of tax owed in Canada is generally what the individual would be required to pay in Canada, but of course the result will vary in different situations.

814. Are U.S. citizens that receive income from property situated in Canada, such as dividends or interest, subject to tax in Canada, and if so, are there withholding requirements?

Yes, there is tax payable on income from property, but a U.S. citizen who is not a resident of Canada is not required to file a Canadian tax return if their only income from Canada is from certain types of "passive income." Common examples of Canadian "passive" income include:

(i) royalties;

(ii) interest;

(iii) dividends;

(iv) rental income; and

(v) pension income.

When royalties or interest, for example, are owed to a U.S. citizen who is not resident of Canada, the payer withholds tax at the time of payment to the non-resident. Thus, the U.S. citizen receives the balance of the funds owed. The general rate of withholding tax is 25 percent, but this may be reduced to a lower rate pursuant to the Canada-U.S. Tax Treaty. Given that the U.S. citizen must also report this income on their U.S. income tax return, there may be relief from double taxation under the Canada-U.S. Tax Treaty and the foreign tax credits available in the U.S. to offset the Canadian taxes paid. The payer of rental income earned by a non-resident must also withhold 25 percent of the gross rents received and remit that payment to the CRA, although there may be an option to reduce the withholding tax by calculating the amount relative to net income earned from the property in the case of real property rentals.

815. Are U.S. citizens employed or carrying on business in Canada subject to tax in Canada, and if so, are there withholding requirements?

The determination of whether an individual is resident in Canada has been refined by common law and is primarily a factual inquiry as outlined in Q 807 to Q 810.[1] Liability for tax in Canada will generally arise on those resident in Canada under section 2(1) of the ITA.

1. http://www.cra-arc.gc.ca/tx/nnrsdnts/cmmn/rsdncy-eng.html CRA: "Determining your residency status" & http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s5/f1/s5-f1-c1-eng.html Income Tax Folio S5-F1-C1 Determining and Individual's Residency Status

U.S. citizens resident in Canada who are employed in Canada will be subject to Canadian tax on their employment income in Canada and on their worldwide income as Canadian resident taxpayers. They will also be subject to U.S. taxation on the same tax base; however, they will get protection from double taxation under the Canada-U.S. Tax Treaty and the Foreign Tax Credit regime to mitigate most, if not all, double taxation. Individuals that relocate to Canada for work on a full time basis are likely to acquire Canadian resident status under the ITA.

U.S. citizens who are not resident in Canada for tax purposes but receive Canadian source income will only be subject to Part 1 tax on the Canadian source income rather than worldwide income.[1] Examples of Canadian source income include:

(i) employment income in Canada; and

(ii) business or self-employment income earned in Canada.

A non-resident of Canada is required to file a special income tax return (a T1-NR Individual Tax Return) in order to report the above sources of income. A non-resident who doesn't have a Canadian social insurance number is required to obtain an individual tax number (ITN), which is a necessity for the filing of a tax return. The ITN can be obtained by completing Form T1261 through the CRA.

In the employment context, typically the employer will withhold and remit tax on the U.S. citizen's behalf, and there is no withholding by the individual. Employers making payments made to non-resident individuals for services provided in Canada must report all such payments to the CRA in a T4A-NR summary, which summary is due by the last day of February of the year following the payment. The employer-payer is also under an obligation to issue a T4A-NR to the individual recipient of the payment (the U.S. citizen). The U.S. citizen will be responsible to file a T1-NR Individual return with the CRA, which would report the information contained in the T4A-NR, and pay any balance owing at that time.[2]

In the case of a business situation, such as a U.S. citizen carrying on self-employed business in Canada or providing services in Canada as a sole proprietor, the individual will also be subject to Part 1 tax on his or her business income. The U.S. citizen will also be required to file a T1-NR Individual Tax Return that requires an ITN. The extent to which there is relief of double taxation under the Canada-U.S. Tax Treaty is dependent on where the permanent establishment of the business is as defined under the Treaty, and the amount of activity carried on through the permanent establishment.

816. What is FATCA, and do I need to be concerned with it as a U.S. citizen living in Canada?

The Foreign Account Tax Compliance Act ("FATCA") is an effort by the U.S. to detect tax non-compliance by U.S. taxpayers with foreign assets, specifically foreign accounts. U.S. citizens

1. http://www.cra-arc.gc.ca/tx/nnrsdnts/ndvdls/nnrs-eng.html CRA: Non-residents of Canada
2. http://www.cra-arc.gc.ca/formspubs/t1gnrl/nnrsdnts-eng.html 2013 Income Tax and Benefit Package (for non-residents and deemed residents of Canada)

living abroad, including in Canada, should be concerned about FATCA if they have not been filing U.S. tax returns annually, even if they have no U.S. sourced income or accounts. This is because U.S. citizens are taxed on their worldwide income regardless of residency.

Effective July 1, 2014, Canadian financial institutions will report to the CRA most bank accounts, mutual funds, brokerage accounts, annuity contracts and some life insurance policies with a cash value. What will not be reported to the CRA are most registered plans such as RRSPs, TFSAs, and RESPs.

U.S. citizens with these accounts or who hold such assets may be contacted by their financial institution to verify their tax residency and U.S. citizenship. This will be done because it is the responsibility of the financial institution to undertake any reporting obligations to the CRA.[1] The CRA can then potentially exchange the information gathered in accordance with the existing provisions of the Canada-U.S. Tax Treaty, which will permit U.S. tax authorities to ensure reporting compliance.

U.S. citizens who are not compliant with U.S. filing requirements may want to consider becoming compliant by means of the IRS Offshore Voluntary Disclosure Program.[2]

817. What is FBAR and do I need to be concerned by FBAR requirements as a U.S. citizen living in Canada?

An "FBAR" is a Report of Foreign Bank and Financial Accounts ("FBAR") that is prepared by a taxpayer and accompanies a tax return. In addition to having to file a U.S. tax return, U.S. citizens with a financial interest in a foreign bank account or brokerage account, for example, that has an aggregate value of over $10,000 during the calendar year is likely responsible for filing an FBAR FinCEN Form 114 with the IRS.[3] FBAR disclosure includes registered Canadian accounts such as RRSPs.

The fact that a U.S. citizen resides in Canada does not alleviate the responsibility of an individual to have to file an FBAR if the individual has a Canadian bank account or other Canadian financial accounts. Thus, U.S. citizens who are not compliant with U.S. filing requirements may want to consider becoming compliant by means of the IRS Offshore Voluntary Disclosure Program.[4]

818. What is the effect of a disposition of Canadian real property?

1) In respect of a U.S. citizen that is a Canadian resident for tax purposes:

Canadian resident taxpayers will be subject to tax on half of the realized capital gains arising from the disposition of Canadian real property (assuming the property is held on capital account as opposed to on income account). That is, only half of the realized capital gains will be subject

1. http://www.cra-arc.gc.ca/tx/nnrsdnts/nhncdrprtng/fq-eng.html CRA: Enhanced Financial Account Information Reporting
2. http://www.irs.gov/uac/Newsroom/IRS-Makes-Changes-to-Offshore-Programs;-Revisions-Ease-Burden-and-Help-More-Taxpayers-Come-into-Compliance IRS: IRS Makes Changes to Offshore Programs; Revisions Ease Burden and Help More Taxpayers Come into Compliance
3. http://www.irs.gov/pub/irs-utl/IRS_FBAR_Reference_Guide.pdf "IRS FBAR Reference Guide"
4. http://www.irs.gov/uac/Newsroom/IRS-Makes-Changes-to-Offshore-Programs;-Revisions-Ease-Burden-and-Help-More-Taxpayers-Come-into-Compliance IRS: IRS Makes Changes to Offshore Programs; Revisions Ease Burden and Help More Taxpayers Come into Compliance

to tax at the individual's marginal rate.[1] If a loss is realized, then such losses are deductible, but only as against other capital gains.

2) In respect of a U.S. individual that is not a Canadian resident for tax purposes:

Real property is generally considered taxable Canadian property.[2] The disposition of taxable Canadian property may lead to a tax liability under the ITA where a capital gain results from the disposition. A non-resident may be liable to pay tax on the capital gain notwithstanding the application of the Canada-U.S. Tax Treaty. In the first instance, there is a requirement under the Canada-U.S. Tax Treaty for the purchaser (who is purchasing property from a non-resident) to withhold taxes from the sale proceeds and deliver only the balance of the sale proceeds to the vendor. However, under Article XIII(3) of the Canada-U.S. Tax Treaty, a capital gain on the disposition of real property will likely be exempt from Canadian tax but subject to U.S. taxation if:

1. The Canada-U.S. Tax Treaty applies to the parties of the transaction;
2. At the time of the disposition, the property is subject to the Canada-U.S. Tax Treaty, and the property disposed of qualifies as treaty-protected (generally this is property that is not a resource property); and
3. The purchaser files with the CRA the appropriate notice. The non-resident will need to complete CRA Form T2062: Request by a non-resident of Canada for a certificate of compliance related to the disposition of taxable Canadian property.[3]

819. Does Canada have estate taxes?

Canada does not have estate taxes. However, the provinces in Canada levy probate taxes. Canadian probate taxes are narrower in application than U.S. estate tax.[4] For example, Ontario probate taxes will apply on assets that are the subject of a will probated in Ontario, but will not apply to real property situated outside Ontario.

U.S. Individuals residing in Canada will need to do their estate planning to consider both U.S. and Canadian tax.

Special care needs to be taken in developing succession plans for U.S. citizens resident in Canada due to the potential for mismatch in tax treatment of individuals in Canada versus the U.S. As these individuals are potentially subject to both the ITA and Internal Revenue Code, care must be taken to ensure that any estate plan is advantageous under both. There are many traps that can catch taxpayers dealing with both systems. Seeking professional advice from

1. http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/rprtng-ncm/lns101-170/127/gns/clclt/menu-eng.html CRA: How do you calculate your capital gain or loss? http://www.cra-arc.gc.ca/E/pub/tg/t4037/t4037-e.html CRA T4037: Capital Gains 2013.
2. Assumes the property is residential or recreation real estate, and does not have any mineral or resource exploitation rights associated with it.
3. http://www.cra-arc.gc.ca/E/pbg/tf/t2062/t2062-08e.pdf CRA.
4. See http://www.attorneygeneral.jus.gov.on.ca/english/estates/estates-FAQ.asp#s5 for Ontario rates.

cross-border proficient advisors is well advised if you are a U.S. citizen who lives in Canada or who has assets situated in Canada.

820. Does a Canadian citizen need to be concerned if the Canadian citizen's spouse is a U.S. citizen?

Generally speaking, no, as the non-U.S. citizen spouse is typically not directly affected by the spouse's U.S. tax obligations. However, greater care must be taken with succession planning, particularly with respect to U.S. estate taxes. U.S. citizens residing in Canada may want to consider arranging their affairs with the Canadian spouse, as having ownership of Canadian based assets can produce some complications for U.S. citizens and certain Canadian assets.

In addition to succession planning, there may be additional considerations arising from the citizenship of any children. Generally, children born to one U.S. citizen parent will be considered U.S. citizens and will be required to meet the same filing obligations as their U.S. parent(s) (with certain exceptions for parents who have never resided in the U.S., or who only resided in the U.S. as a young minor, in which case there may be exceptions that are beyond the scope of this publication; it is recommended to seek U.S. citizenship counsel from an immigration lawyer on this matter).

Finally, a U.S. citizen should be cautious about making contributions to a "Registered Education Savings Plan ("RESP") for children. RESPs are not tax-deferred investment vehicles like RPPs or RRSPs. Rather, they enable an individual to save for the post-secondary education of a "beneficiary", which usually is the child but can also be the grandchild of the individual. The tax benefit of RESPs does not come from the ability to deduct contributions from income, which means that contributions are paid with after-tax dollars. However, the contributions to an RESP offer 3 important advantages:

(1) The Canadian government will provide a grant equal to 20 percent of the contributions made, up to a $500 annual limit and a $7,200 lifetime limit (these limits may increase from time to time, depending on amendments made by the Canadian federal government);

(2) The growth in the RESP is non-taxable until withdrawn; and

(3) When withdrawals are made, they are taxed in the hands of the beneficiary, and not the contributor. Typically, the beneficiary is in a lower tax bracket than the contributor, thereby adding to the tax benefit that is received between them.[1]

The tax treatment of RESPs may be different if the contributor is a U.S. citizen or a Canadian one. The basis for the distinction lies in the fact that the contributions made to an RESP are not tax-deferred for U.S. purposes and may be considered by the IRS as a foreign grantor trust. The contributions are not subject to similar special relief as contributions made to RRSPs. As a result, a U.S. citizen that is subject to U.S. tax and contributes to an RESP for the benefit of a beneficiary may be faced with an unexpected tax liability as any of the income, interest, or

1. Section 146.1 of the ITA contains the complete rules for RESPs.

capital gains, as well as any of the Canadian government grants will be considered income of the contributor. Ultimately, it may be best to have the non-U.S. parent contribute to an RESP, or to avoid RESPs all together and use an alternate planning tool.

821. What considerations apply to U.S. citizens who participate in Canadian retirement plans (such as RRSPs) while residing in Canada?

There are several types of tax-assisted private pension or retirement plans, and they function differently depending on the participants involved and the structure of the plan. There are registered pension plans ("RPPs")[1] and deferred profit sharing plans ("DPSPs"),[2] which are employer-sponsored pension plans that benefit employees working in Canada, and involve contributions made by both the employer and the employee. These differ from registered retirement savings plans ("RRSP")[3] and registered retirement income funds ("RRIFs")[4] in that these are individual plans and only the individual or the spouse of the individual can contribute to his or her own plan. An RPP, DPSP and an RRSP matures in the year the individual turns 71, which means that the total value of an individual's RRSP is included into income in that year, unless the individual "rolls" his or her RPP, DPSP or RRSP into a RRIF (essentially on a tax-free basis), or in the case of an RRSP alone, into an RRSP annuity (also on a tax-free basis).[5] In this manner, RRIFs are simply extensions of RRSPs that can also be self-administered, with certain restrictions that are imposed on the individual such as annual mandatory withdrawals.

The tax benefit available with RPPs, DPSPs, RRSPs and RRIFs is in the form of a tax-deferral, which is a benefit to the individual because of the time value of money. The individual contributions to the plan(s) are deductible against income in the year the contributions are made, and are not taxable to the individual until the contributions are withdrawn (with two notable exceptions being withdrawals to participate in either the Home Buyer's Plan[6] and/or the Lifelong Learning Plan[7]). The tax on the contributions is thereby "deferred" to the year of withdrawals. There are limits on the amount of contributions an individual can make in a given year, which limits are defined by an individual's "earned income," participation in other plans, employer-dictated contribution limits and statutory maximum contributions. In addition, there may be other tax benefits, such as:

(1) Any growth on the contributions within the plan are tax-exempt and are not taxed until withdrawn;

(2) Typically, at the time the individual begins to withdraw from an RRSP or a RRIF, the individual is retired and is therefore in a lower tax bracket. The amount of tax

1. Subparagraph 56(1)(a)(i) of the ITA.
2. Paragraph 56(1)(i) of the ITA.
3. Paragraph 56(1)(h) of the ITA. Also see http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/rrsps-eng.html CRA: Registered Retirement Savings Plan.
4. Paragraph 56(1)(t) of the ITA.
5. Subsection 146(16) of the ITA.
6. Section 146.01 of the ITA. The Home Buyer's Plan assists first time home buyers by permitting a maximum withdrawal of $20,000 that is put toward the payment of a first home, and the withdrawal is not included into income in the year of the withdrawal, but rather is included in stipulated annual installments that are included into the individual's income over 15 years.
7. Section 146.02(1) of the ITA. The Lifelong Learning Plan operates much like the Home Buyer's Plan. The maximum withdrawal of $10,000 is put towards the individual's education, and stipulated annual installments are included into the individual's income over 10 years, starting no later than 5 years after the withdrawal.

owed on the contributions would likely be less than the amount of tax that would have been owed by the individual in the year the contribution was made;

(3) Pensioners are entitled to split pension income with their spouses, which again may reduce the amount of tax owed in the year of withdrawal;[1] and

(4) There is a pension credit available on the first $2,000 of pension income, which means that the first $2,000 of pension income is essentially received tax-free.

For a U.S. citizen subject to taxation under the U.S. tax code, RRSPs do not qualify for the tax deferral granted by the ITA. However, Article XVIII(7) of the Canada-U.S. Tax Treaty provides some relief. U.S. citizens with RRSPs must file IRS form 8891 to obtain the deferral. This form must be filled out for each RRSP account.

822. Is renouncing U.S. citizenship a viable option to citizens permanently living in Canada?

Leaving aside any significant non-tax considerations, rescinding one's U.S. citizenship may not necessarily be the answer to ongoing U.S. tax requirements and potential liabilities. There is an expatriation tax under the U.S. IRC that will apply citizens who have renounced their citizenship.[2] The consequences and tax liabilities that result from rescinding U.S. citizenship may prove to be onerous, and professional tax and/or legal advice is strongly recommended in this circumstance. The benefits that are provided for under the Canada-U.S. Tax Treaty are designed to ameliorate the ongoing tax consequences that are borne by U.S. citizens living or working in Canada.

823. Does a U.S. citizen living in Canada need to be concerned of the "Medicare Tax," and if so, is there tax relief for it?

U.S. citizens living in Canada have many considerations that should be taken into account, only some of which are discussed here. In addition to the filing requirements already outlined above, U.S. citizens should be aware of the Net Investment Income Tax, or "Medicare Tax" as it has become colloquially known. U.S. citizens who historically have not had any U.S. income tax liability may be subject to this new tax at a rate of 3.8 percent if they have 'net investment income' (generally investment income such as interest, dividends, capital gains, etc. less permitted expenses related to that income such as brokerage fees and interest expenses) and they have a modified adjusted gross income over $200,000 if single, or $250,000 and filing jointly, Unfortunately for U.S. citizens subject to this tax, it seems unlikely that foreign tax credits can be used to reduce or eliminate this tax liability as the Net Investment Income Tax is not imposed by Chapter 1 of the U.S. Code and foreign tax credits are only applied as against chapter 1 taxes.

1. Subsection 60.03(1) of the ITA. This section provides that up to 50 percent of pension income can be split with a spouse or common-law partner for tax purposes. The term "common-law partner" includes both common law spouses and same-sex partners pursuant to the definition in s. 248(1) of the ITA.
2. http://www.irs.gov/Individuals/International-Taxpayers/Expatriation-Tax IRS "Expatriation Tax".